

[Auditor's Home Page](#)

[List of Audit Reports](#)

Table of Contents

EXECUTIVE SUMMARY	Click Here To View	..... i
INTRODUCTION		..... 1
BACKGROUND		..... 2
SCOPE AND METHODOLOGY		..... 4
FINDING		
Controls Over The Manual Check Preparation Process Are Adequate But Additional Procedures And Documentation Would Be Helpful		..... 5
Risk Analysis		..... 5
Manual Check Controls		..... 6
Review Of Controls Over Manual Payroll Checks		..... 11
Additional Procedures		..... 13
Policies And Procedures Need To Be Documented		..... 14
CONCLUSION		..... 15
RECOMMENDATIONS		..... 16
ADMINISTRATION'S RESPONSE	Click Here To View	..... 17
APPENDIX A	Click Here To View	
DEFINITIONS OF PRIORITY 1, 2, AND 3		
AUDIT RECOMMENDATIONS		..... A-1

INTRODUCTION

This report covers our review of the Administration's controls over manually prepared payroll checks. The audit was approved in the City Auditor's 1988-89 Workplan. We conducted this review in accordance with generally accepted government auditing standards, and limited our work to those areas specified in the Scope and Methodology section of this report.

Section 805(a) of the City Charter states in part that:

“The City Auditor shall ... conduct or cause to be conducted annual post audits of all the fiscal transactions and accounts kept by or for the City. Such audits shall include but not be limited to the examination and analysis of fiscal procedures and the examination, checking and verification of accounts and expenditures...”

Accordingly, we reviewed the Administration's controls over manually prepared payroll checks.

We selected manual payroll checks as our audit subject because of its inherent susceptibility to potential losses. Our objective was to determine whether the Administration's controls over manually prepared payroll checks provide reasonable assurance that the City is protected against errors and irregularities.

BACKGROUND

In 1987, the City disbursed over \$248 million for payroll expenditures. Of this total, the City used 2,723 manually prepared checks to disburse \$57 million (23%). Computer generated checks, automatic deposits to employee bank accounts and bank wire transfers were the other ways funds were disbursed through the payroll bank account.

The Payroll Unit of the Finance Department prepares checks manually for numerous types of payments. The following Table 1 summarizes manual check disbursements in 1987.

Table 1
Summary Of Manual Check
Disbursements In 1987

Payment Type	<u>Number of Checks</u>	<u>Amount</u>	<u>Average Dollar Amount</u>
Deduction Remittances	805	\$55,456,838.42	\$68,890.48
Replacements	294	1,107,193.78	3,765.97
Attachments	1,062	381,872.77	359.58
Attorney Liens	62	206,352.75	3,328.27
Advances	147	53,388.77	363.19
Refunds	261	34,118.56	130.72
Prepayments	61	27,768.19	455.22
Special Checks	<u>31</u>	<u>8,080.84</u>	<u>260.67</u>
Totals	<u>2,723</u>	<u>\$57,275,614.08</u>	<u>\$21,034.01</u>

The above types of manual check payments vary from regular and recurring to one-time payments. For example, the City issues some manual checks, such as deduction remittances, on a regular basis. Deduction remittances include amounts deducted from employees' salaries for taxes and benefits. These deductions include remittances to the Internal Revenue Service, State Franchise Tax Board, insurance carriers, credit unions and employee organizations. The City also uses manual checks for the payment of court-ordered attachments which are deducted from designated employees' pay. Attorney liens from workers' compensation claims are also paid using manual checks. These types of payments are made over a limited period of time or until the balance has been paid. Finally, manual checks are used for one-time payments. These payments include salary advances, prepayments¹, refunds to employees, replacements for lost or incorrect checks and other special need checks.

Manual checks provide the Administration with check writing flexibility. However, this flexibility also creates additional risk if not properly controlled.

¹ The Payroll Unit uses this term for the situation where an employee is due a check, but the computerized payroll system does not generate a check.

SCOPE AND METHODOLOGY

We identified the inherent threats associated with manual check processing and determined if current controls reasonably mitigate those threats.

We reviewed the general procedures for issuing manual checks. We also concentrated our risk analysis on the processing of manual checks for advances, prepayments, refunds and replacements.

FINDING

CONTROLS OVER THE MANUAL CHECK PREPARATION PROCESS ARE ADEQUATE BUT ADDITIONAL PROCEDURES AND DOCUMENTATION WOULD BE HELPFUL

In 1987, the City of San Jose issued 2,723 manual payroll checks worth more than \$57 million. Our review revealed that the Finance Department has a system of controls that provides reasonable assurance that these checks are adequately protected against inherent manual check writing threats. However, we determined that two additional review procedures would provide added control over manually prepared payroll checks. Finally, we found that Finance needs to document critical manual check control procedures. Such documentation ensures that staff will properly execute important procedures and that the City will not lose institutional knowledge when key employees leave City service.

Risk Analysis

With the help of Finance Department personnel, we prepared a risk assessment of the manual payroll check writing process. By so doing, we determined the potential for losses to the City from the various threats that are intrinsic to manually prepared payroll checks. We computed or estimated the number of items susceptible to individual threats, the occurrence rates of errors absent any controls, and the average dollar amount for those items susceptible to the threats. We also estimated the extent to which existing controls mitigate the various threats we identified.

We identified the following threats for City of San Jose manually prepared payroll checks:

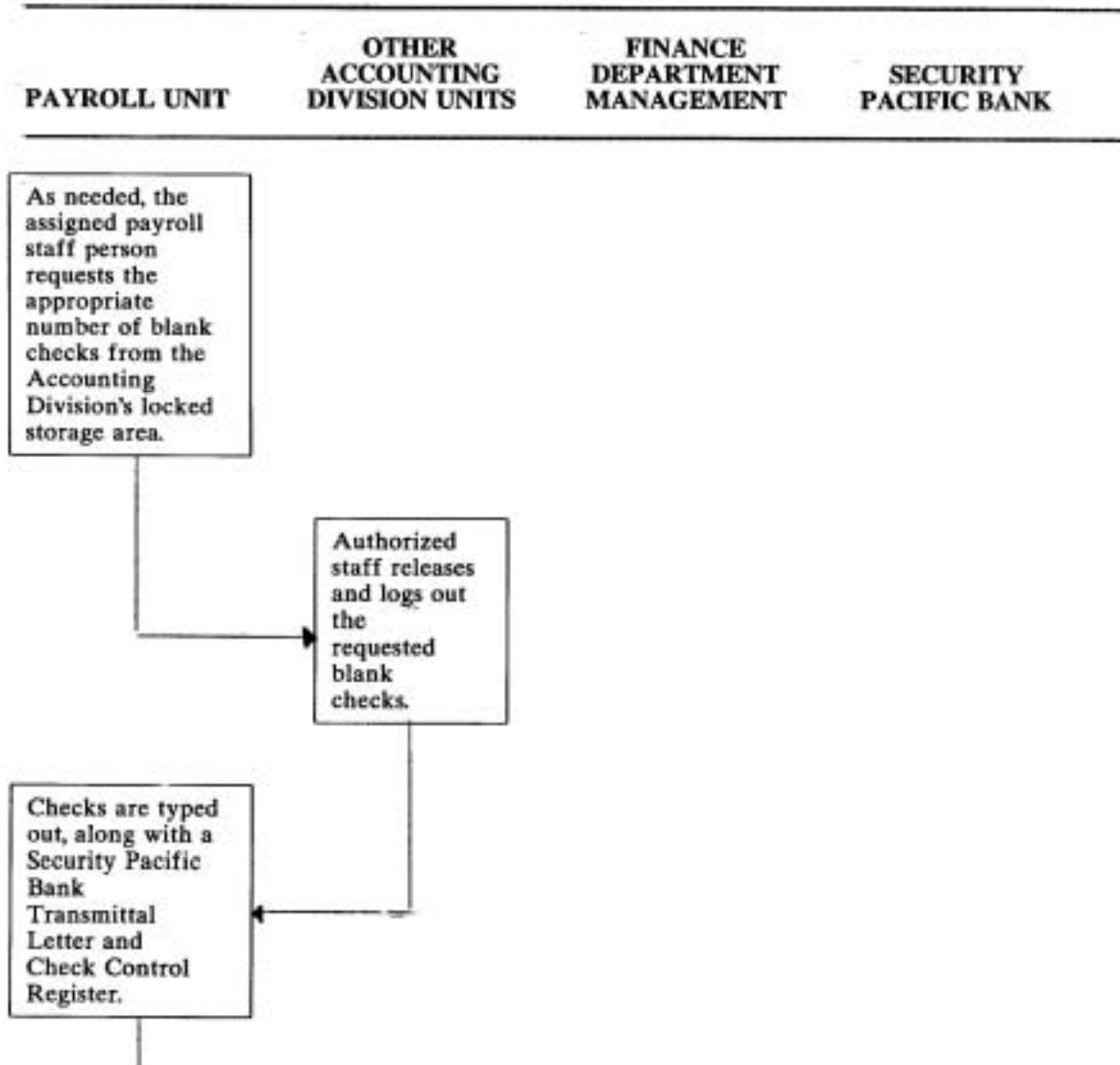
- Checks issued for unauthorized purposes,
- Checks not properly authorized,
- Checks for incorrect amounts,
- Checks not properly recorded,
- Advance Checks not recovered or recovered late,
- Checks for duplicate payments,
- Advance checks recovered more than once,
- Checks issued to fictitious employees or payees,
- Checks lost or stolen,
- Checks prepared late,
- Checks issued to a terminated employee,
- Refund checks issued for an invalid reason,
- Refund checks issued in excessive numbers,
- Checks issued to the wrong employee,
- Check issuance not documented,
- Refund checks issued without corresponding adjustments, and
- Check information not sent to Accounting.

Manual Check Controls

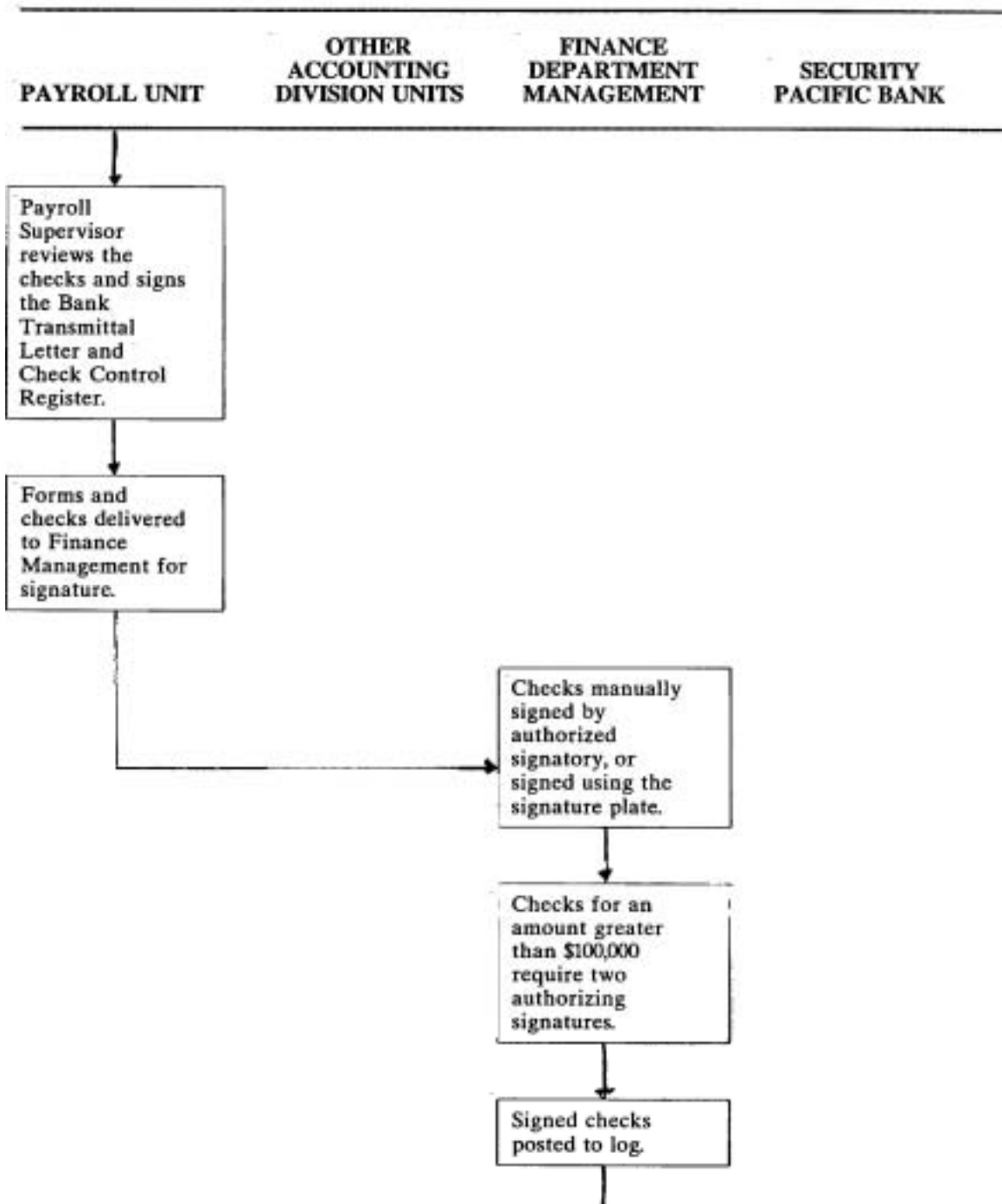
We found that the Administration's controls over the manual checking process provide reasonable assurance that the threats listed above are sufficiently mitigated. The Administration's internal control system includes proper segregation of duties among various Finance Department units. In addition, our tests of the key controls revealed that Finance Department staff consistently executed critical control procedures.

The following flow chart describes the manual check writing process procedures and the general controls built into that process.

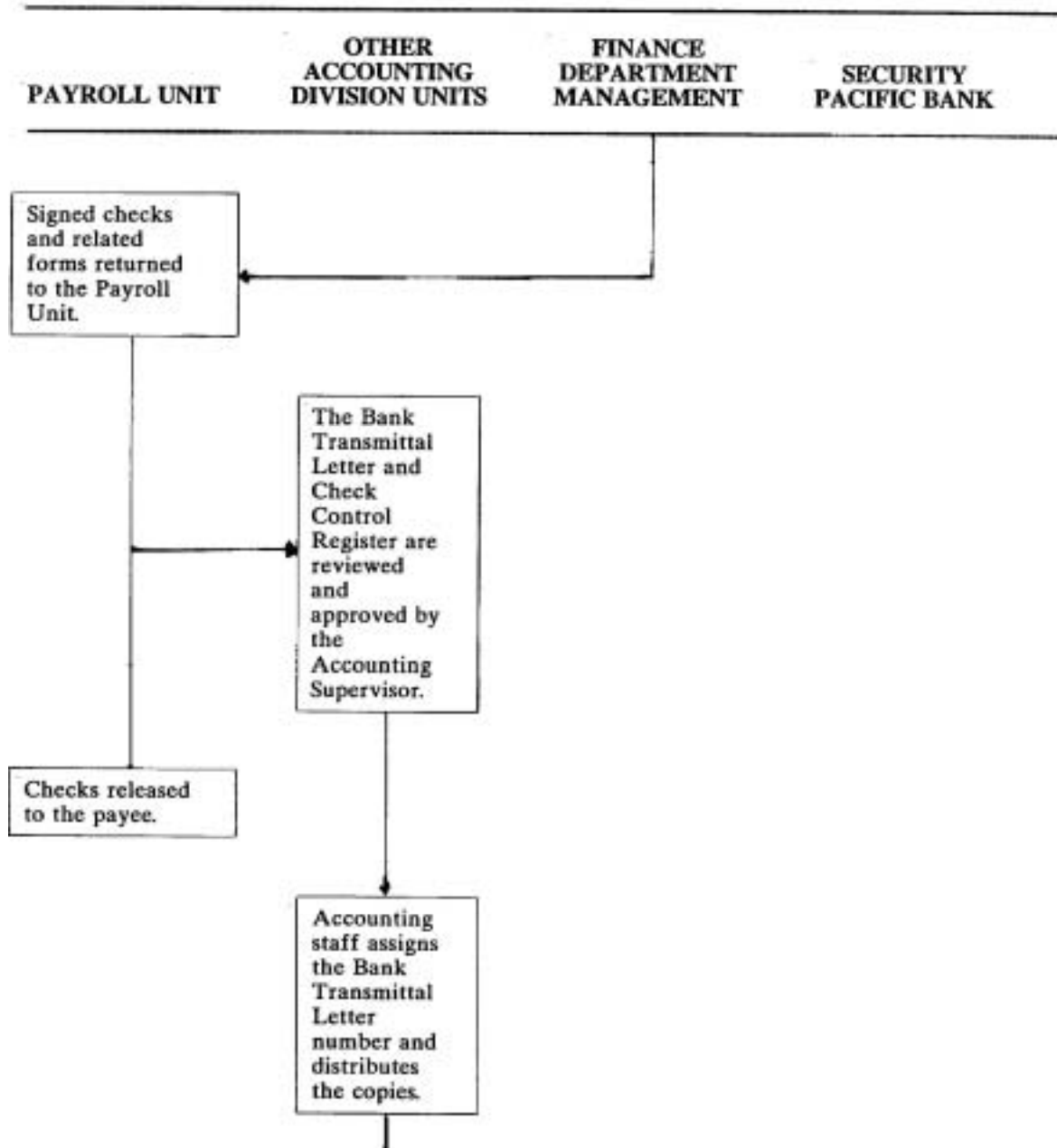
PAYROLL SYSTEM - MANUAL CHECK PROCESS



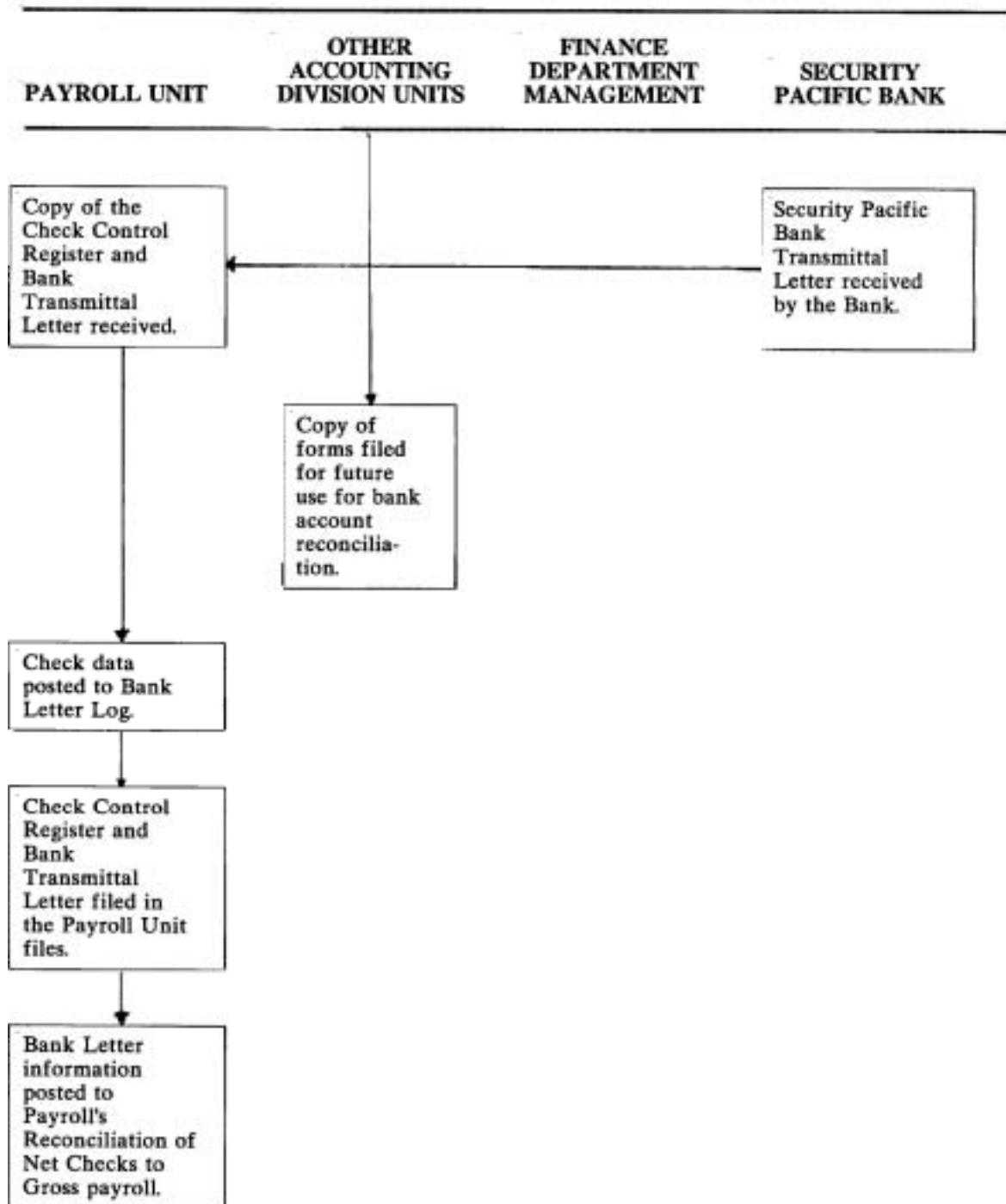
PAYROLL SYSTEM - MANUAL CHECK PROCESS



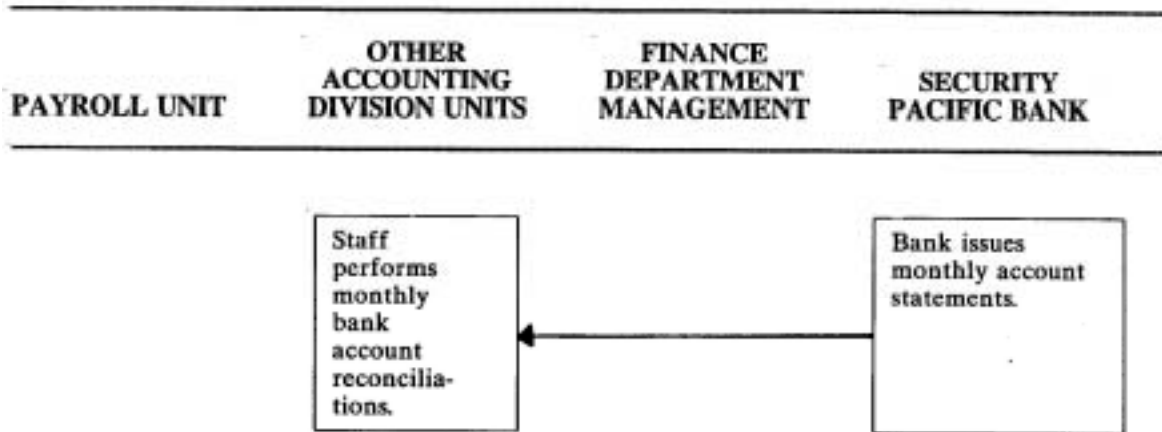
PAYROLL SYSTEM - MANUAL CHECK PROCESS



PAYROLL SYSTEM - MANUAL CHECK PROCESS



PAYROLL SYSTEM - MANUAL CHECK PROCESS



Review Of Controls Over Manual Payroll Checks

We identified the following control procedures as the most critical for mitigating threats pertaining to manual payroll checks for advances, prepayments, refunds and replacements:

- Approvals of the Bank Letter documents,
- Physical defacing of cancelled checks,
- Recording of cancelled checks,
- Bank Letter recording of check issuances, and
- Confirming Stop-pays before issuing a replacement.

If consistently performed, these control procedures significantly mitigate risk. Our objective was to determine if these procedures were consistently followed.

Our tests revealed that the Finance Department consistently performed these critical control procedures for manually prepared payroll checks issued in 1987. Specifically, we tested all 516 Bank Letters processed in 1987 for appropriate review and approval. Only two Bank Letters lacked an Accounting Division management signature on the face of the bank transmittal letter. However, we did find the Accounting Division Supervising Accountant's signature on the check control register forms supporting these bank transmittal documents.

In addition, we found the control procedure for the physical defacing of cancelled checks works effectively. All 103 of the cancelled checks we were able to locate were properly rendered non-negotiable.

Further, of the 106 checks cancelled in 1987 for which replacement checks were subsequently issued, we were able to trace 104 to their recording on the bank letter forms. The remaining two cancellations were replaced early in 1987 and may have been recorded as cancelled in the prior year's documents. We did not pursue the remaining two unresolved cancelled checks. The results of this test show that the recording of check cancellations was performed consistently.

We also tested 95 of the 763 manual payroll checks issued in 1987 for proper recording on Bank Letter forms. We found no exceptions for the 95 checks tested.

Finally, we tested all 116 manual payroll checks issued in 1987 to replace stop-payments. The purpose of our test was to verify that the bank had confirmed stop-payments before replacement checks were issued. We found no exceptions for the 116 checks tested.

In addition to our detailed testing, we determined that adequate separation of duties exists over certain manual payroll check processes. For example, Accounting Division General Ledger Section staff control access to the supply of blank checks. Staff log the release of blank checks as they are needed. Restricted access to the blank checks protects against checks being used for unauthorized purposes.

Further, Payroll Unit staff record manual check transactions on standardized forms. These forms document the check number, the dollar amount of the checks and a brief description of the transaction. General Ledger Section staff control these forms and assign sequential reference numbers to the forms. The City's bank receives copies of the Bank Transmittal Letter as the source of account activity information. The General Ledger Section also uses these documents for a source of information when it reconciles the bank account. These forms provide evidence that the Payroll Unit Supervisor and Accounting Division Management have reviewed and approved the transactions.

Additional Procedures

Finance Department Management are authorized to sign manually prepared checks. Their staff frequently uses a signature stamp machine to apply the authorizing signature to the check. The signature stamp machine has a removable signature plate. Controls over the use of this machine include reconciling the number of checks used with the number of signatures applied. A counter on the signature stamp machine supplies the count used for reconciliation purposes.

Although the use of the signature stamp machine was well controlled, improvements are possible. Specifically, current procedures do not require an authorized person in the Accounting Division to determine that a disbursement has been approved before the check is signed. Documentation reflecting such approval is provided with the checks to be signed. Therefore, it would be relatively easy for someone to review for

approval before checks are signed. In our opinion, such a review for proper authorization reduces the likelihood that unauthorized manual checks would be processed through the signature stamp machine. We also feel that the possibility of misuses of manually prepared payroll checks would be lessened if Finance developed procedures for instances when proper disbursement authorization is missing.

A key manual payroll check control procedure is the Payroll Unit Senior Accountant's reconciliation of all payroll disbursements with the total gross payroll. This reconciliation documents the balancing of payroll system disbursements with the gross payroll amount. Because the payroll reconciliation is such a critical control, the next higher level of Accounting Division management should review and initial the reconciliation. Such a review would provide a routine means for Accounting Division management to review the summary of the payroll system activity and to assess the proper functioning of the system.

Policies And Procedures Need To Be Documented

Although the Administration's manual payroll check procedures are established and effectively working, we found that most of the process has not been documented. Finance should prepare written manual payroll check policies and procedures. Such documentation will help ensure that staff will properly execute important procedures and that the City will not lose institutional knowledge when key employees leave City service.

CONCLUSION

Our review revealed that the Finance Department has an adequate system of controls over manual payroll checks. However, we determined that two additional review procedures would provide additional control and that Finance needs to document critical manual check control policies and procedures.

RECOMMENDATIONS

We recommend that the Finance Department:

Recommendation #1:

Determine that disbursements are authorized before using the signature stamp machine to sign manual payroll checks. (Priority 3)

Recommendation #2:

Require an Accounting Division Manager to review and initial the Senior Accountant's payroll reconciliation. (Priority 3)

Recommendation #3:

Prepare written policies and procedures for the manual payroll checking process. (Priority 3)

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